Managing Financial Crisis: A Critical Review of China's Policy

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Abstract

The study examined the financial crisis and their impact on world economies, particularly China. The study compares the Southeast Asian financial crisis and the recent US based crisis of subordinated debt conduction in Chinese context. Then, it analyzed the impact of financial crisis in three areas: economic growth potential, social conflicts and respond to risks. Conclusions were made on the basis of data and literature discussed. Policy recommendations have been forwarded for the Chinese government as well as other developing economies for policy adjustments in three areas. Namely, stable economic growth needed to expand domestic demand to compensate for the decline in current account surplus. At the same time, the direct use of radical fiscal stimulus measures to increase household income and consumer spending, reducing the potential social conflicts arise and monetary policy measures, especially the internationalization of Chinese Yuan to rapidly out of recession.

Keywords: Financial crisis, China, CNY, Economic growth, Monetary Policy

1. Introduction

The financial crisis in developed countries has traumatized all world markets. Consequently the world economy is facing the most severe slowdown since the 1930s. The economic decline following the financial crisis primarily caused lower growth rates in developing countries. For example, growth forecasts in Cambodia show a fall from more than 10% in 2007 to close to zero in 2009, and Kenya may achieve only 3-4% growth in 2009, down from 7% in 2007(Wikipedia, 2007).

The consequence of banking crisis in rich countries and emerging markets has common impacts. There are broadly similar patterns in housing and equity prices, unemployment, government revenues and debt (Reinhart and Rogoff 2008b). Developing countries were not responsible, but they have been affected by the crisis. In some developing countries, the effects have been much more severe than in the developed countries.

In this study researchers discussed the impact of recent financial crisis on China's economy and China's new financial policy against the backdrop of the global financial crisis. The remainder of the paper is structured as follows; literature about financial crisis and their impact on developing economies especially China is discussed in the section two. The comparison of Southeast Asian financial crisis and recent financial crisis originated from US in China's perspective are analyzed in section three. China's capacity to deal with financial crisis is discussed in section four. Methods to deal with financial crisis are discussed in section five, and the article concludes in section six.

2. Recent Financial Crisis Impact on China

No country, however, is spared from the consequences of the downturn. As the figure 1 indicates the severe impact of financial crisis on overall world. The global economic recession have considerable impacts in developing countries, like lower growth rates, unemployment crisis. The developing countries were mainly affected in finance and trade. This has affected the trade balance, balance of payments and foreign reserves of some countries and a few are already facing a new debt crisis. The developing countries have also experienced slower GDP growth (China 13.1% in 2007 to 8.7% in 2008, India (9.3% in 2007 to 7.3% in 2008), zero growth (Malaysia) or a decline in GDP (Korea, Taiwan, Singapore).

Insert figure 1 here

According to the financial crises history, financial crises are now appearing in increasing scale. The frequency intervals between these financial crises became shorter. From the Great Depression of 1929 to the first crisis in U.S. interval was of 31 years, whereas after that an average of 3 years was observed in occurrence of a financial crisis as indicated in figure 2. Therefore a proactive response by the countries is desired in such situations.

Insert figure 2 here

China's economy is on the rise over the past several years, and has been a key contributor to world economic growth. China's economy has continued 8–10 percent per annum healthy GDP growth for nearly a decade now. Despite the recent financial crisis and a slowdown in the economy, Chinese economy still managed to hit 7–8 percent growth in 2009. However, the recent global financial crisis considerably slowed down China's economy.

Different studies viewed differently the impacts of recent financial crisis on China. Zhang (2009) described that the current crisis will have a significant and negative impact on China. N'Diaye et al. (2009) estimated that a 1% slowdown in the G-3 economies is likely to cause more than 2% growth decline in the emerging Asia market.

The slowdown has had a major impact on the Chinese labor market. Many jobs have been shed in export-oriented manufacturing sectors, and official industrial employment declined. However at the same time, new jobs have been created, largely in services, construction, and the public sector, and overall conditions on the labor market are not as bad as feared earlier, although significant numbers of people have had to accept lower wage jobs in the process. Nation-wide, employment and wage growth slowed substantially in 2009, but remained positive. Both official wage growth and rural "per capita" wage income growth picked up again somewhat in the third quarter of 2009.

Insert figure 3 here

The current account surplus of China has declined materially, but reserve accumulation has continued. The trade surplus has fallen because of the trade volume developments. However, large improvement in the terms of trade due to the sharp fall in raw commodity prices limited the decline. The current account surplus, however, fell by US$ 60 billion year on year basis in the first half to 6.4% of GDP. On the capital and financial account, after falling in the first 7 months year on year, FDI showed positive year on year growth in August and September 2009, as financial conditions eased globally and China's economic prospects remained relatively favorable. Foreign reserves accumulation speeded up in the third quarter, with the total reaching $2.3 trillion in 2009, although a substantial part of that rise is due to valuation gains because of the depreciation of the US dollar against other major currencies.

3. The Southeast Asian Financial Crisis and the Recent Financial Crisis

Since 2007 the United States subordinated debt passed to the global financial crisis, profound impact on financial and economic markets, has led to a considerable number of corporate bankruptcies, falling profits and increasing unemployment. Consequently, the Chinese government tight "double prevention" policy was changed to the "prudent and flexible" monetary fiscal policy, such as the introduction of four trillion fiscal stimulus plans. How can China successfully through the crisis, to seek help and for better policy options we have compared recent financial crisis with the Southeast Asian financial crisis.

In the financial crisis history, the Southeast Asian financial crisis also had profound impacts on China. In 1997, the eruption of a hedge fund headed by George Soros began in Thailand and quickly spread to the whole of Southeast Asia. In a short time nearly six months, many Southeast Asian countries stock market crash down, the financial system and the whole economy severely traumatized. Many countries in the region observed currency devaluation. The first devaluation of the Thai Baht was soon followed by that of the Philippine Peso, the Malaysian Ringgit, the Indonesian Rupiah and, to a lesser extent, the Singaporean Dollar (Garay, 2003). Over the same period, the stock markets in Southeast Asian region, has fallen by 30% to 60%. It was estimated that in this financial crisis, foreign exchange markets and the stock markets of only the Southeast Asian countries have been affected. Economic losses amounted to more than 100 billion U.S. dollars, experiencing a severe recession in the region as well. However, China due to its stable macroeconomic policies and not free Chinese Yuan (CNY) conversion policy was less immune and continued to maintain high growth of 6.53% in 1999.

The financial crisis inevitably, annihilate the real economy, and even lead to severe recession and depression, however fast-growing economy could keep its effects to minimum through appropriate economic and monetary policies measures. In this regard the researchers compared and analyzed china's policy in two severe financial crises. First, from the perspective of economic growth, the impact two crises put on China's economic growth are analyzed. Table 1 indicated the impact of two financial crises on China's economic growth.

Insert Table 1 here

Despite of a drag on GDP growth all over the world, China still is the first choice of foreign direct investment in place. However under the current account surplus of negative growth, mainly due to economic recession in Europe and the United States and other developed countries led to a drop in demand. The situation is optimistic; in investment in recent years the growing budget surplus for the implementation of expansionary fiscal policy has a good foundation, and the pull of China's fixed asset investment growth rate of GDP is also the main engine of growth continued to increase. There is little room for optimism that the consumer has been showing declining trend.

Therefore, policies to driving consumer spending are to implement, as are discussed in next section.

Secondly, the crisis caused a global panic, through worldwide bankruptcies. Therefore, in order to prevent a social unrest the government should concentrate on issues, including unemployment, inflation and the fair distribution of resources for economic and social stability.

Insert Table 2 here

The table 2 indicates the social contradictions in two crises; the misery index indicates a far more rise in 2008 than in 1997 and 1998. Although inflation rates are high, but considering the prices of bulk commodities and raw materials continued to drop, as well as the economic downturn, the inflation is not currently considered a major macro-economic issue. However rising unemployment will cause social instability. Another important concern is proportion of personal disposable income falling. Consequently on one hand social welfare may be imperfect and on the other hand more expansion in the distribution mechanism is not satisfactory so that residents are the biggest beneficiaries and potential social conflicts may arise. Hence, decision-makers need to carefully consider the most urgent task, to increase revenue to stimulate domestic demand, but also reduce social conflicts.

Insert figure 4 here

Contrast can be seen in figure 4 from 1978 to 2007; GDP grew 68 times, however, household disposable income increased only 40 times. In figure 5 per capita disposable incomes in proportion to GDP reflects the declining trend. At the same time from a historical point of view, in the founding of the People Republic of China in 1951, private consumption accounts for 68% of the then GDP, government consumption 16.5% of the GDP, today private consumption is only 37.5% of GDP, government consumption is 28% of GDP. For a major portion of population, the wage is their only source of income. While wages at a level below the growth rate of GDP, so thrust to increase direct income of inhabitants will be effective for stimulating domestic demand.

Insert figure 5 here

4. China’s Capacity to Deal with Financial Crisis

This study analyzes China's capacity to confront such crisis from three aspects ability to pay debt, financial health and profitability of its firms.

Insert Table 3 here

Table 3 indicates a continuous increase in foreign exchange reserves during both crises, even the rapid growth of foreign exchange reserves exceeds the GDP level. This has a good effect in dealing with international financial crisis. As a result of bank shareholding system reform and the introduction of modern management theory, bank deposit-loan ratio has fallen significantly. Profitability of the business indicates that return on equity has greatly increased over the recent crisis; hence China’s capacity to deal with financial crisis remains strong and has very good fight against the financial crisis.

5. 3 Methods to Deal with Financial Crisis

Presently Chinese government has to address three key issues, maintaining the economic growth, avoiding social contradictions and improving the ability to cope with financial crisis. The question is how to stimulate consumption, how to stimulate domestic demand, thereby reducing the reliance on GDP growth in fixed investment and export promotion, especially China's import and export trade in 2007 has been accounted 60% of the GDP. Excessive dependence on US dollars reserves, as in case of financial crisis would be a serious blow. After the Southeast Asian financial crisis, the Asian countries have greater dependence on foreign trade. Economic performance indicated that Southeast Asian crisis lead to heavy dependence on export-oriented national models. These "East Asian models" put serious setbacks, in those countries in Southeast Asia after the financial crisis into a long recession. Therefore, to correctly handle the "export-oriented economy" and "inward-looking economy" relationship, under the conditions of globalization and opening up the national economy, a reasonable and balanced structure should also be long-term national strategy in China.

To combat the effects of the slowdown, the Chinese government recently announced an aggressive fiscal stimulus as indicated by table 4. Much of these expenditures have gone toward investment projects and partly toward strengthening the social safety net. It is a package that tries to blend together short-term stimulus with longer-term objectives of developing infrastructure in underdeveloped parts of the country and boosting consumption (Eswar, 2009).

In the short run, China needs export growth in order to maintain job growth and preserve social stability. As China continues to run current account surpluses by exporting to the United States and other advanced country markets, it has little alternative to buying U.S. Treasuries with the reserves it accumulates while managing its exchange rate

(Eswar, 2009).

Some further steps which already have been taken needs more focus, to rebalance and boost domestic demand. These steps include, increasing further the presence of the government in health, education, and social safety; improving access to finance in rural areas and for SMEs development more generally; and mitigating resource use and environmental damage (China Quarterly Update, 2009).

Insert Table 4 here

Many researchers have discussed CNY internationalization strategies. Zhong (2002) puts forward an idea of combining the process of CNY capital account convertibility with that of CNY internationalization. Ba (2007) points out that CNY internationalization should undergo the three stages of currency liberalization, regionalization and globalization. Li and Liu (2008) put forward the idea of a dual-track reform. Li et al. (2004) present the view of CNY "Asianization." However, CNY internationalization is basically a spontaneous process pushed by market demand. Yi (2006) points out that an economic powerhouse cannot give up monetary sovereignty, and that monetary competition is the most sophisticated form of competition between major economic powers. He suggests that the current sustained trade surplus should be utilized to push the influence of the CNY both regionally and internationally.

6. Conclusion

The Chinese government in these times of crises can do a "bone healing" approach, in the macro-policies to reduce labor and capital input to economic growth. Strategies are required to the promotion of domestic demand, rather than relying on fixed investment and to boost the economy by boosting demand (Paul, 2005). Chinese government needs following changes in policy adjustments to cope with such financial crisis and come out of recession. First, total dependent on foreign trade for the ability to recover after the financial crisis is not effective. Hence to address the need for the stable economic growth expansion in domestic demand is required to compensate for the decline in current account surplus. Second, use direct aggressive fiscal stimulus measures to increase household income and consumer spending, reducing the potential social conflicts arise. This in turn will help in achieving better and positive effects of fiscal policy by expanding domestic demand and a good mass base. Third a more flexible foreign exchange policy, efforts to promote the internationalization of the CNY, and more freedom to take expansionary monetary policy is required.

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Table 1. China's Economic Growth Potential

Year	Net exports		Investment		Consumption
	Foreign Direct Investment (100 million U.S. dollars)	Current account surplus (100 million U.S. dollars)	The proportion of GDP, fiscal surplus	Investment in fixed assets (million)	Household consumption expenditure to GDP ratio (%)
1997	452.7	404	-0.74%	19194.2	45.2
1998	454.63	434	-1.09%	22491.4	45.3
2007	747	2621	4.45%	117413.9	35.4
2008	900	2614	-0.80%	136372.3	N/A

Source: National Bureau of Statistics, Foreign Exchange, Wall Street Journal, the World Bank, IMF, UBS.

Table 2. Potential Social Conflicts

Year	Misery Index	Employment	Income Distribution	Inflation	
		Unemployment Rate	Disposable personal income / per capita GDP	CPI	PPI
1997	5.9%	3.10%	0.80	2.80%	-4.20%
1998	2.32%	3.10%	0.79	-0.78%	-0.32%
2007	8.8%	4%	0.72	4.80%	3.14%
2008	9.95%	4.05%	0.94	5.9%	6.9%

Note: misery index = unemployment + inflation rate (CPI) A

Source: National Bureau of Statistics, Ministry of Labor.

Table 3.China's Ability to Deal with Financial Crisis

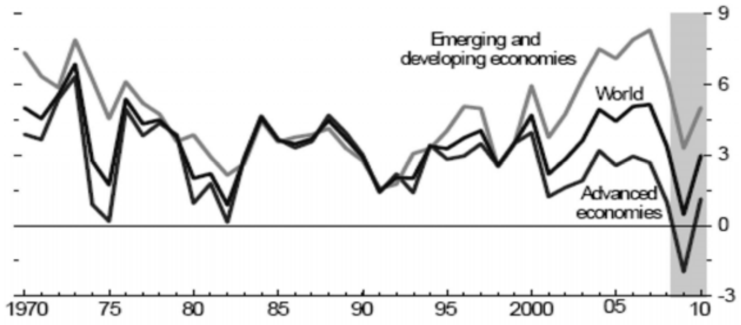
Year	The Ability to Pay Debt	Financial Health	Profitability of the Business
	Foreign exchange reserves (100 million U.S. dollars)	Banking savings and loan rates	Rate of return on equity of industrial enterprises
1997	1398.9	90.50%	4.70%
1998	1449.59	90.40%	3.70%
2007	15282.49	67.20%	16.10%
2008	21000	65.20%	17.70%

Source: National Bureau of Statistics, the State Administration of Foreign Exchange

Table 4. Government Spending on Education, Health Care and Social Security (% of GDP)

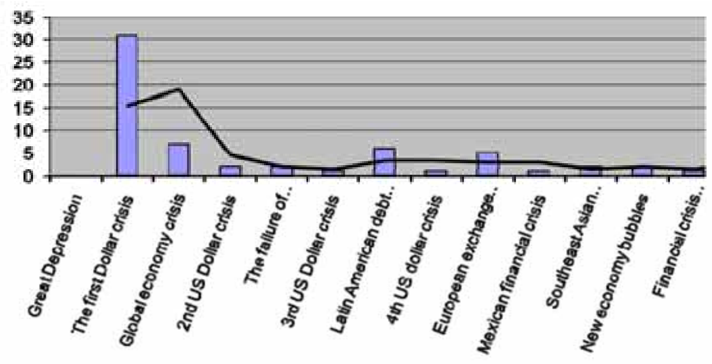
	2002	2003	2004	2005	2006	2007	2008	2009
Total	7.8	7.6	7.5	7.7	8.0	8.7	9.5	10.3
Education	2.2	2.2	2.1	2.2	2.3	2.8	3.0	3.2
Medical & Health care	0.5	0.6	0.5	0.6	0.6	0.8	0.9	1.2
Social security & employment	2.2	2.0	1.9	2.0	2.1	2.1	2.3	2.5
Spending from social security fund	2.9	3.0	2.9	2.9	3.1	3.1	3.3	3.4

Source: Ministry of Finance China



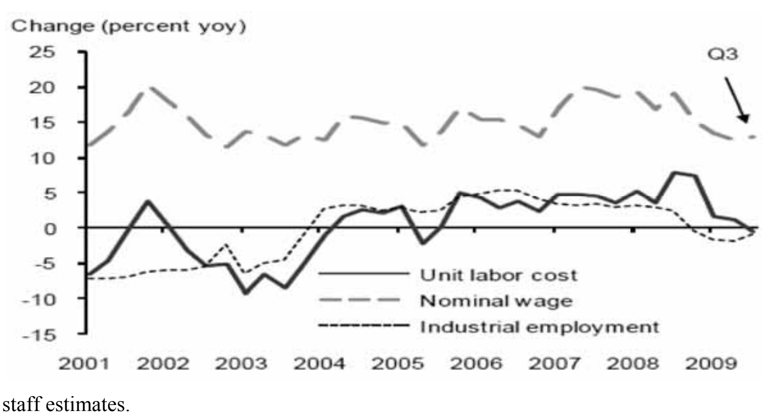
Source: IMF, "World Economic Outlook Update", January 2009.

Figure 1. Growth Rates (Real GDP) in Developed & Developing Countries



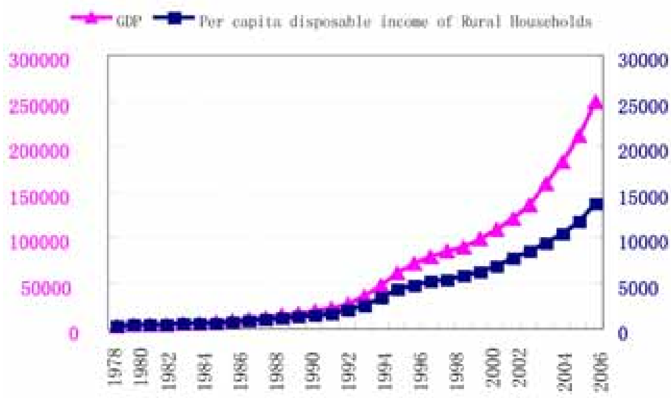
Source: World Bank, IMF

Figure 2. Interval between Worlds Financial Crises



Source: CEIC, World Bank staff estimates.

Figure 3. The Labor Market Conditions



Source: National Bureau of Statistics

Figure 4. GDP and Per Capita Disposable Income of Rural Households

Source: National Bureau of Statistics

Figure 5. Disposable income / GDP ratio per capita